IN THE

Supreme Court of the United States

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MICHAEL RODAK, JR.,

October Term, 1974

No. 74-46

EQUITY SECURITIES CORPORATION, a Corporation and EQUITY FUNDING CORPORATION, and LYMAN SPURLOCK, an Individual,

Petitioners,

vs.

MARY F. EL KHADEM,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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vs.

MARY F. EL KHADEM,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

The petitioners, Equity Funding Securities Corporation, Equity Funding Corporation of America, and Lyman Spurlock, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in this proceeding on March 20, 1974.

Opinions Below.

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto. A memorandum opinion, not reported, was rendered by the District Court for the Southern District of California and appears in the Appendix hereto.

Jurisdiction.

The judgment of the Court of Appeals for the Ninth Circuit was entered on March 20, 1974. A timely petition for rehearing *en banc* was denied on May 10, 1974, and this Petition for Certiorari was filed within ninety days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1)

Question Presented.

Is a loan transaction a "security" as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934, solely because the loan proceeds were used to purchase registered securities which were used as part of the collateral for the loan?

Statutory Provisions Involved.

United States Code, Title 15:

§77b. Definitions

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

United States Code, Title 15:

§78c.(a) Definitions

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Statement of the Case.

Reduced to their simplest form, the material facts in this case are as follows:

(1) Petitioner Equity Funding Securities Corporation (Equity) is a broker-dealer in securities and a wholly owned subsidiary of petitioner Equity Funding Corporation of America. Petitioner Lyman Spurlock was a registered representative employed by Equity.

(2) Pursuant to advice given by Spurlock, respondent borrowed $40.000 from a lending institution (Nationwide Investment Company) for the purpose of purchasing shares in a mutual fund selected by her.

(3) Respondent delivered to the lender her promissory note* for $40,000, prepaid interest for five years on the note, a loan and security agreement, and the mutual fund shares purchased with the loan proceeds plus $7,000 cash collateral.

(4) Respondent's motive in entering into the transaction was to get a tax advantage from prepaying interest plus a profit from any rise in the value of the mutual fund shares purchased with the loan proceeds.

(5) The lending institution wrongfully pooled the collateral posted by respondent with collateral posted by other borrowers and used this pooled collateral to secure its own borrowings. When it was unable to meet its obligations, its lenders foreclosed on the pooled collateral, and respondent lost her collateral.

(6) There was no connection between Nationwide (which has not been named as a defendant in this action) and any of the petitioners herein except that Nationwide loaned respondent the money with which the mutual fund shares were purchased through Equity. The sole role of Equity was to purchase on behalf of respondent the mutual fund shares which were registered securities and for which a prospectus was delivered.** There is no claim of any wrongful or improper act in regard to the selection, purchase or sale of the mutual fund shares.

As a result of the foregoing facts, respondent brought an action against petitioners in the District Court for

*The District Court specifically held that the promissory note was not a security and, therefore, that question is not involved.

**The transaction was a simple, straight-forward loan to purchase securities. It did not involve the combined purchase of insurance and mutual funds which has been widely referred to as "equity funding" or "funding" in the press and judicial decisions.

the Southern District of California alleging violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 with federal jurisdiction allegedly being conferred by these Acts on the theory that petitioners "sold" respondent an unregistered security when they advised her to enter into the loan transaction with Nationwide. Petitioners moved to dismiss the action for lack of jurisdiction of the subject matter on the ground that the loan transaction was not a security and the District Court granted that motion with leave to amend. Respondent then filed an amended complaint and petitioners' motion to dismiss was denied as the District Court concluded that the entire series of transactions between respondent and the lender constituted an "investment contract". The District Court certified the question for interlocutory appeal pursuant to 28 U.S.C. §1292(b) and the Court of Appeals for the Ninth Circuit granted leave to appeal. The Court of Appeals affirmed the order of the District Court and remanded the case for further proceedings.

REASONS FOR GRANTING THE WRIT.

The decision below conflicts with the principles established by this Court as to the tests to be applied in determining whether or not a particular transaction constitutes an investment contract. While these tests have ostensibly been applied, they have been so distorted as to render them meaningless and, as a result, someone who borrows money is deemed to be furnishing capital to the lender, someone who has a financial incentive to enter into a loan transaction is deemed to share in the earnings and profits of the lender, and any borrower who runs a risk of loss of his collateral is deemed to have invested in a common enterprise with other borrowers from that lender. However, even more important than this serious distortion of the tests of an investment contract is the fact that the decision below, if allowed to stand, means that every banker, broker or other lender of money is actually the issuer of an unregistered security if the loan proceeds are used to purchase stock and the loan is secured by collateral. Such a holding is of vital concern and importance to the entire financial community of this country as it will have a significant effect on the manner in which such transactions are conducted. Furthermore, the case presents an issue which is significant in the administration of the statutes involved and it presents an important and clear-cut issue of law which is fundamental to the further conduct of the case. Finally, the case is one of first impression.

(1) The Decision Below Conflicts With Principles Established by This Court.

The District Court and the Court of Appeals both held that the series of transactions between respondent and Nationwide constituted an "investment contract"

and, therefore, a security. A leading case on the subject of what constitutes an investment contract, and the case specifically relied upon by respondent and the Court of Appeals, is *Securities and Exchange Commission v. Howey* (1946), 328 U.S. 293, 90 L.Ed. 1244, In that case the investors had purchased interests in real property consisting of units of acreage in a citrus grove and entered into service agreements covering the management and operation of their acreage. The investors had no right of entry to market the crop and no right to specific fruit. All of the fruit from all of the acreage owned by defendants and the investors was pooled at picking, and defendants accounted to the investors only for an allocation of the net profits. In holding that the purchase and service transactions, when considered together, constituted investment contracts, this Court stated the rule as follows:

> "Thus all the elements of a profit seeking business venture are present here. The investors [1] provide the capital and [2] share in the earnings and profits; [3] the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed."
>
> *SEC v. Howey,* at p. 300.

While recognizing the three-part test outlined by this Court in *Howey,* as set forth above, the Court of Appeals misconstrued those principles and held as follows:

> (a) When respondent borrowed money from Nationwide for the purpose of purchasing mu-

tual fund shares, and delivered to Nationwide her promissory note and the mutual fund shares as collateral, she provided "capital" to Nationwide;

(b) Since respondent had a financial incentive to enter into the loan transaction with Nationwide in the form of an opportunity to gain a tax advantage and to acquire investment leverage in the mutual fund shares, this was the equivalent of sharing "in the earnings and profits" *of Nationwide* for purposes of the *Howey* test;

(c) Since all borrowers from Nationwide had a risk of loss of their collateral if Nationwide failed, then the fortunes of the borrowers were commonly dependent upon the success of Nationwide's business operations and there was the required "common enterprise".

We submit that the Court of Appeals misconstrued each portion of the three-part test established by this Court in the *Howey* case. First, respondent was not investing in Nationwide nor furnishing it capital, but rather was *borrowing* capital from Nationwide so that respondent could invest the borrowed money in mutual funds. To say that one who borrows money from a lender is actually providing capital to the lender is to render the accepted and common understanding of those words meaningless.

Second, respondent did not intend to and could not share in the earnings or profits of Nationwide. The fact that she did have a financial incentive to borrow money from Nationwide and to invest that money in mutual fund shares does not mean that she was "investing" in Nationwide nor sharing in its earnings and profits.

Finally, there was no "common enterprise" which was managed, controlled, or operated by anyone. Each borrower from Nationwide determined the particular securities in which he wished to invest and the success or failure of that investment was dependent solely upon the issuer of the particular securities the borrower selected.

As more fully set forth in the following section of this petition, the Court of Appeals has, in effect, held that all secured borrowings are in themselves securities and this is of extreme importance and concern to the entire financial community of this country.

(2) The Decision Below Is of Extreme Importance and Concern to the Financial Community of This Country.

This is a case of first impression and, if the decision below is allowed to stand, it means that every bank and other financial institution in the country which makes a secured loan to a borrower for the purchase of securities, as every bank does almost every day, and every stockbroker which has a margin account with its customers, is in fact issuing an unregistered security every time it enters into such a loan transaction. The consequences of such a holding are enormous.

There is nothing unique or different about the basic Nationwide transaction to distinguish it from loans made every day by banks, brokers and other types of financial institutions. The only difference, and the real cause of this action, is the fact that the lender in this case wrongfully converted the collateral pledged to it and, when the lender became insolvent almost two years later, respondent was unable to redeem her collateral.

When a bank or other financial institution makes such a loan, the pattern of the transaction is the same as that which is involved in this case. The customer comes to the bank or other financial institution and requests a loan for the purpose of buying securities. The borrower executes a note and a collateral agreement and may or may not prepay interest. The stock is purchased with the loan proceeds and is delivered to the bank as collateral against the loan. The customer also must give the bank either money or additional collateral as the bank requires a "margin" (value of collateral over the amount of the loan) both for compliance with law and for its own protection.

A margin transaction with a broker works substantially the same way. The customer comes to the broker and places an order to purchase securities on margin. Instead of signing a promissory note and a collateral agreement, the customer signs a margin agreement which has substantially the same effect as it contains an agreement to pay on demand any balance due and authorizes the broker to rehypothecate the borrower's collateral. The securities are purchased with the broker's money (the loan) and are delivered to the broker as collateral. The customer is required to deposit with the broker cash or other securities as additional collateral in whatever amount is required by the current margin regulations, as neither a bank nor a broker can lend more than a fixed percentage of the value of the securities to be purchased without collateral in addition to the securities themselves.

Whether the customer borrows money from a bank or other financial institution (including Nationwide) or enters into a margin transaction with the broker, the

operative facts are essentially the same. The customer purchases securities on the basis of (1) his credit in the form of a note or other promise to pay, (2) the value of the securities to be purchased with the loan proceeds and pledged to the lender, which can then rehypothecate that collateral to secure its own borrowings, and (3) additional cash or securities given to the lender as additional collateral representing the difference between the value of the securities purchased and the amount which can be legally loaned against that purchase. Thus, the lender ends up with the borrower's promise to pay the sum borrowed plus collateral with a value substantially in excess of the amount borrowed.

Obviously, there was a security involved in the instant transaction as there is in the typical situations described above. Plaintiff was purchasing shares of a mutual fund—clearly a security. These shares were registered with the Securities and Exchange Commission and the customer received the necessary prospectus. However, the securities which are purchased with loan proceeds must not be confused with the loan made to finance such purchase. The fact that a loan is made so that the borrower can purchase a security does not make the loan itself a security.

If the decision below is allowed to stand, any such borrower from a bank or other financial institution is unknowingly furnishing "capital" to that lender and "investing" in that lender as that borrower will furnish the lender with rehypothecatable collateral and a promissory note or other agreement to pay which that lender can use to obtain money to provide capital for its own operations.

If a "financial incentive" to enter into a transaction in the form of an opportunity to gain a tax advantage and/or acquire investment leverage is to be equated with this Court's tests of sharing in "the earnings and profits", then all borrowers whose purpose in borrowing is to invest to make a profit are in reality "investors" in the lender. We submit that that was not the test contemplated by the Congress or by this Court and actually renders that test meaningless.

If the fact that the failure of a lender will result in the loss of collateral of borrowers constitutes a "common enterprise", then all borrowers from banks and other financial institutions are "investors" in a "common enterprise" as, if the lending institution fails, the collateral will be lost and all the borrowers will suffer alike. This renders the "common enterprise" test promulgated by this Court meaningless.

Each test announced by this Court in the *Howey* case has been distorted beyond recognition and rendered meaningless. The result of this distortion is that all secured loans are securities and that all borrowers are investors. This creates an impossible situation for the financial community and urgently requires correction.

The questions presented by this Petition are not only of vital concern to the financial community but they are also significant in the administration of the statutes involved. If such loan transactions actually constitute the issuance of investment contracts, then the Securities and Exchange Commission has significant enforcement problems on its hands. So far as Petitioners know, the Securities and Exchange Commission has never treated such loan transactions as securi-

ties and has no rules or regulations governing them. For this reason the questions presented by this Petition should be decided by this Court.

(3) The Decision Below Presents an Important and Clear-Cut Issue Which Is Fundamental to the Future Conduct of the Case.

Petitioners have set forth in the preceding portions of this Petition the questions of law which are presented by the decision below. An immediate resolution of those questions should materially advance the termination of the litigation. The litigation will be terminated and trial on the merits will be unnecessary if it is determined that the loan transaction between respondent and Nationwide did not constitute a security. Otherwise, it will be necessary to complete discovery and prepare and try the case and subsequently present this issue by way of appeal from an adverse verdict or judgment. The decision on the questions of law at this point may very well save inconvenience and expense of a trial and subsequent appeal.

Conclusion.

We submit that the decision below seriously misconstrues and distorts the tests set forth by this Court in the *Howey* case for determining what kinds of transactions constitute an investment contract for the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934. As a result of this misconstruction and distortion thousands of loans which are being made on a daily basis by banks, brokers and other financial institutions in this country are actually unregistered securities. This holding has horrendous consequences to the entire financial community

and presents a question of extreme importance. The questions presented are also of significance in the administration of the statutes involved and should be decided promptly so that all concerned may know whether such loan transactions are securities whose issuance must be regulated. The case presents a clear cut issue of law which is fundamental to the further conduct of the case. For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,

JOHN L. ENDICOTT,
Attorney at Law,
Counsel for Petitioners.

APPENDIX.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals, for the Ninth Circuit.

Mary F. El Khadem, *Plaintiff-Appellee*, vs. Equity Securities Corporation, a Corporation and Equity Funding Corporation, and Lyman Spurlock, an Individual, *Defendant-Appellant*. No. 72-1380.

[March 20, 1974].

Appeal from the United States District Court for the Southern District of California.

Before: WRIGHT and TRASK, Circuit Judges, and BYRNE, Sr.,* District Judge.

WRIGHT, Circuit Judge:

This is an action to recover damages for alleged violations of the Securities Act of 1933, the Securities Exchange Act of 1934, and state law. Defendants moved to dismiss, claiming that the case does not involve the purchase or sale of a "security" and therefore neither the Securities Act nor the Securities Exchange Act confer jurisdiction on the district court.[1] The district court held that the case does involve the sale of a se-

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*Of the Central District of California. Judge Byrne participated in the oral argument and conference on the case, but did not participate in the opinion, having died on March 9, 1974.

[1]Although the motion was framed by defendants and treated by the district court as a motion to dismiss for lack of subject matter jurisdiction, it is more properly characterized as a motion to dismiss for failure to state a claim under the Securities Act of 1933 or the Securities Exchange Act of 1934. The question whether the case involved a security was itself a federal question, and since the case involves more than $10,000 the district court had *jurisdiction* under 28 U.S.C. § 1331.

curity and denied the motion to dismiss. Appellants appeal,[2] and we affirm.

I
BACKGROUND

Defendant Equity Securities Corporation is a registered and licensed dealer-broker of securities and is a wholly owned subsidiary of defendant Equity Funding Company of America. Defendant Lyman Spurlock is an investment advisor, employed by Equity Securities and acting as its agent. During the period in question, Lyman Spurlock served as investment counsellor to plaintiff, Mary El Khadem.

In her amended complaint, Ms. El Khadem alleged the following series of events. In 1968, Mr. Spurlock advised her to invest in a plan offered by Nationwide Investment Corporation.[3] Under this plan Ms. El Khadem borrowed $40,000 from Nationwide to purchase mutual funds that in turn were pledged as collateral for the loan. Ms. El Khadem was also required to pledge cash collateral and to prepay interest. The plan afforded Ms. El Khadem a tax advantage derived from prepaying interest and gave her investment leverage in anticipation of a rising market.

Under the Nationwide agreement, Ms. El Khadem was required to pledge securities to Nationwide, including the mutual funds purchased with the borrowed $40,000, valued at 175% of her indebtedness. Nation-

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[2]This is an interlocutory appeal pursuant to 28 U.S.C. § 1292 (b). Appellants have complied with the requirements of that section.

[3]There is no connection between defendants and Nationwide other than the fact that defendants recommended the Nationwide investment plan to plaintiff.

wide was given the power to rehypothecate her collateral, up to the amount of her indebtedness, and pledge it to secure Nationwide's own borrowings for business purposes. Nationwide was also given the power to assign Ms. El Khadem's promissory note.[4] The agree-

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[4]Paragraph 10 of the loan and security agreement provided:

> LENDER shall have full and complete right and power to assign this agreement or any part thereof, and to rehypothecate for LENDER'S financing purposes any or all collateral of BORROWER to secure LENDER'S borrowings in an amount not to exceed (a) BORROWER'S indebtedness to LENDER decreased by any unearned interest prepaid by BORROWER or increased by any accrued earned interest due LENDER; and (b) further increased by an amount not to exceed one-half of one percent (½%) of the original amount of this loan for each year and pro rata portion thereof of the unmatured portion of the initial ten year term of this loan; and (c) further increased by an amount not to exceed ten percent (10%) of the original amount of this loan. With respect to (c), above, LENDER shall only have the foregoing right and power to borrow the amount so determined provided either of the following conditions are satisfied: (1) LENDER assigns to BORROWER'S collateral account LENDER'S otherwise unpledged mutual fund collateral equal in liquidation value to no less than one hundred fifty percent (150%) of the amount so borrowed, and upon the further condition that LENDER shall immediately sell such collateral if the indebtedness against such collateral shall amount to eighty percent (80%) or more of the liquidation value thereof; and in the event of such sale, LENDER shall reduce its indebtedness on BORROWER'S collateral in an amount equal to LENDER'S actual borrowings as authorized in this Section 10(c); or, (ii) LENDER assigns to BORROWER'S collateral account equity in already pledged mutual fund collateral equal in liquidation value to no less than three hundred percent (300%) of the amount so borrowed, but the total indebtedness at the time LENDER so borrows, including the original amount of BORROWER'S loan, against such mutual fund collateral shall not exceed seventy-five percent (75%) of the liquidation value thereof; and if the total indebtedness against such collateral shall amount to eighty percent (80%) or more of the liquidation value thereof, LENDER shall immediately sell such collateral, and in the event of such sale, LENDER shall re-

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ment did not require Nationwide to include in an assignment of her promissory note a provision that collection was conditioned upon return of the collateral to Ms. El Khadem. Nor did the agreement limit Nationwide's power to rehypothecate Ms. El Khadem's collateral to situations where Nationwide's creditors could foreclose only if Ms. El Khadem did not honor her promissory note.

Following a drop in the stock market, Ms. El Khadem was required to deposit more collateral to meet the 175% requirement. On the advice of Nationwide and defendants, she borrowed an additional $34,230 under conditions similar to the original $40,000 loan. The collateral, which then totaled $83,180, was converted to U.S. Treasury Bills.

The Nationwide plan was not registered as a security and no prospectus was issued. In June 1970, the Securities and Exchange Commission charged Nationwide with selling unregistered securities in violation of the Securities Act of 1933 and with fraud in violation of section 10b of the Securities Exchange Act of 1934. Thereafter, Nationwide suffered financial problems and was placed in receivership. Nationwide's creditors foreclosed on collateral pledged to them, in-

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duce its indebtedness on BORROWER'S collateral in an amount equal to LENDER'S actual borrowings as authorized in this Section 10(c); (d) LENDER'S right and power to borrow and rehypothecate, as provided in Section 10 (c), above, shall at all times be subject to BORROWER'S call on a one-day demand basis and shall not affect BORROWER'S collateral requirements as heretofore set forth in this agreement. LENDER'S pledge or pledges shall have no responsibility or requirement to determine whether its loan or their loans to LENDER meet the aforesaid loan limitations and shall be fully protected on any loan or loans made by it or them against the security of LENDER'S rehypothecated collateral.

cluding Ms. El Khadem's rehypothecated Treasury Bills. She now claims the value of her lost collateral as damages in this action.

Stripped of its formalities, the Nationwide plan was essentially as follows: Ms. El Khadem supplied Nationwide with cash and securities, in the form of prepaid interest and rehypothecatable collateral, and the use of her credit, in the form of an assignable promissory note, to capitalize Nationwide's business ventures. Nationwide used this capital for its own business purposes by rehypothecating it and pledging it to secure Nationwide's own borrowings. In return for supplying Nationwide with venture capital, Ms. El Khadem received a tax benefit and investment leverage.

The only question before this court is whether the Nationwide plan was a "security" as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. We hold that it was.

II

WAS THE NATIONWIDE PLAN A SECURITY?

The Securities Act of 1933 and the Securities Exchange Act of 1934 define a "security" as including an "investment contract."[5] The district court held that

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[5]Section 2(1) of the Securities Act of 1933 provides:

> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee

(This footnote is continued on next page)

the Nationwide plan was an "investment contract" and therefore a "security" as defined by the Acts.[6]

As this court recently noted in *S.E.C. v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 480-81 (9th Cir. 1973), the Securities Act of 1933 and the Securities Exchange Act of 1934 are remedial legislation requiring broad and liberal construction. *See S.E.C. v. W. J. Howey Co.*, 328 U.S. 293, 299 (1946); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967). The Acts must be interpreted liberally to effect their purpose of ensuring full and fair disclosure to purchasers of securities and protecting the public from speculative or

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of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77(b)(1).

Section 3(a)(10) of the Securities Exchange Act of 1934 provides:

> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issurance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c(a)(10).

[6]The district court also held that the mere fact that plaintiff signed a "note" did not bring the transaction within the scope of the Acts. This portion of the district court's judgment has not been appealed, and we intimate no opinion concerning it.

fraudulent schemes of promoters.[7] *S.E.C. v. Glenn W. Turner Enterprises, Inc., supra* at 480-81. Thus, in *S.E.C. v. Joiner Corp.*, 320 U.S. 344, 351 (1943), the Supreme Court noted that

> the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing which establish their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security' ".

Similarly, the Court has noted that the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits," *S.E.C. v. W. J. Howey Co., supra* at 299, and that while "searching for the meaning and scope of the word 'security' in the Act, form should be disregarded for substance and the emphasis should be on economic reality," *Tcherepnin v. Knight, supra* at 336.[8]

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[7]The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; . . . .

S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933).

[8]For examples of the varied plans which have been held to be securities, see cases cited in *S.E.C. v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 481 n.6 (9th Cir. 1973).

In light of the foregoing, we must determine whether the economic realities of the Nationwide plan, rather than its formal structure as a loan and security agreement, are such that it is an "investment contract" as the district court held. Our principal guidance is derived from *S.E.C. v. W. J. Howey Co., supra.*

In *Howey,* the Court held that a real property transfer of citrus groves, together with an agreement whereby the grantor cultivated and marketed the crops, was an investment contract and therefore a security as defined by the Acts. The Court stated that "[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.* at 301. The Court relied on the facts that "[t]he investors provide[d] the capital and share[d] in the earnings and profits; the promoters manage[d], control[led] and operate[d] the enterprise." *Id.* at 300.

Defendants contend that the Nationwide plan does not meet the test laid down in *Howey.* First, they argue that Ms. El Khadem did not provide Nationwide with capital but rather that she received investment capital in the form of a loan. Notwithstanding the fact that Ms. El Khadem received a loan for investment purposes, however, she did provide Nationwide with capital for its business operations in the form of rehypothecatable collateral and an assignable promissory note.[9] It was with this capital that Nationwide could finance its business ventures. Putting their argument slightly differently, appellants argue that under the Nationwide plan as written, Ms. El Khadem bore no risk

[9]Because we hold that the collateral and promissory note were capital, we need not decide whether the prepayment of interest was also a transfer of risk capital to Nationwide.

of losing her capital. This is merely another way of saying that Ms. El Khadem did not provide Nationwide with risk capital at all. Since her collateral could be rehypothecated only in an amount not exceeding her indebtedness to Nationwide, appellants contend that she could not suffer any out-of-pocket loss. The mere fact that Nationwide rehypothecated her collateral in violation of this limitation should not, appellants suggest, render a plan a security that was not a security when written.

Appellants correctly point out that the Nationwide plan must be analyzed as of the time Ms. El Khadem agreed to it. If subsequent acts by Nationwide in violation of the agreement could convert the plan into a security, legitimate expectations would be defeated. Appellants are mistaken, however, in their contention that Ms. El Khadem risked no loss, and therefore did not provide risk capital, under the plan as written. Since her capital could be rehypothecated only to the extent of her indebtedness, she risked loss only if it were possible both to lose the rehypothecated collateral and to be required to pay on the promissory note. An examination of the agreement reveals this possibility.

Although the promissory note was not negotiable,[10] Nationwide seemingly retained the right to assign Ms. El Khadem's obligation free of a duty to redeem her collateral. The agreement granted Nationwide "full and complete right and power to assign this agreement or any part thereof, *and*, to rehypothecate for [Nationwide's] financing purposes any or all collateral of bor-

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[10]The promissory note was subject to the conditions of the security agreement, and was not, therefore, negotiable. *See* Cal. Comm. Code § 3105(2)(a).

rower," [emphasis added] limited to Ms. El Khadem's indebtedness. The use of the conjunctive form implies that Nationwide intended to retain the right to assign the obligation to one assignee and repledge the collateral to another. Since Ms. El Khadem technically consented to this separation of the obligation and the collateral, collection could be made on the promissory note notwithstanding a foreclosure on the collateral.[11] Therefore, by agreeing to the Nationwide plan Ms. El Khadem subjected herself to a risk of financial loss.

Second, appellants contend that Ms. El Khadem did not share in the profits of Nationwide. She was, however, provided a financial incentive by Nationwide to invest in their plan in the form of an opportunity to gain a tax advantage and to acquire investment leverage. It is true that unlike the situation in *Howey*, the financial gain for Ms. El Khadem did not vary from year to year depending on the skill with which Nationwide managed her collateral. Rather, only the risk of loss varied with Nationwide's management skills. But this distinction between the Nationwide plan and the *Howey* plan is without significance when determining

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[11]We need not decide that state law would permit this interpretation in a form contract drafted by the lender. We merely hold that Nationwide attempted to construct an arrangement in which the borrower risked out-of-pocket loss.

Appellant argues that our interpretation of Nationwide's right to assign and rehypothecate is contrary to Cal. Comm. Code § 9207(2)(e) which provides:

> The secured party may repledge the collateral upon terms *which do not impair the debtor's right to redeem it.* (Emphasis added.)

This restriction is applicable, however, only "[u]nless otherwise agreed." Cal. Comm. Code § 9207(2).

whether the plan is a security. The distinction is precisely that between a common stock and a corporate bond, yet a corporate bond is not for that reason excluded from the definition of a security.[12] Therefore, the fact that Ms. El Khadem's "profit" was constant while her risk of loss depended on Nationwide's management skills does not remove the plan from the definition of a security.

Third, appellants argue that Ms. El Khadem did not invest in a "common enterprise" as required by *Howey*. Appellants rely on the fact that while Nationwide pooled Ms. El Khadem's collateral with that of other borrowers, the pooling was in violation of the agreement. Therefore, appellants argue, the Nationwide plan as written did not put Ms. El Khadem's collateral into a "common enterprise" with the collateral of others.

Assuming that the pooling was in violation of the agreement,[13] Ms. El Khadem nevertheless invested in a "common enterprise." This court has defined a "common enterprise" as "one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or or of third parties." *S.E.C. v. Glenn W. Turner Enterprises, Inc., supra* at 482 n.7, citing *Los Angeles Trust Deed & Mortgage Exchange v. S.E.C.*, 285 F.2d 162, 172 (9th Cir.), *cert. denied* 366 U.S. 919 (1961). Ms. El Khadem's risk of loss was interwoven with

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[12]*See* 15 U.S.C. § 77(b)(1), 78c(a)(10).

[13]It is not clear that pooling was, in fact, in violation of the agreement, since no provision explicitly proscribed pooling.

Nationwide's financial success, as was the risk of the other Nationwide borrowers. Even if each borrower's collateral could not be pooled with that of others, the fortunes of the borrowers were commonly dependent upon the success of Nationwide's business operations.

In conclusion, the Nationwide plan was an investment of risk capital. Ms. El Khadem risked financial loss in order to gain certain financial advantages. Nationwide sought the use of Ms. El Khadem's capital, in the form of credit and collateral, for its own business purposes. Ms. El Khadem's risk depended on the skill with which Nationwide conducted its business ventures and managed her collateral and promissory note. It is precisely this type of risk venture that the Securities Act of 1933 and the Securities Exchange Act of 1934 were designed to control. Therefore, we hold that the Nationwide plan was a security as defined by the Acts.[14]

The order of the district court is affirmed. The case is remanded for further proceedings.

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[14]Appellant suggests that by holding the Nationwide plan a security we hold virtually all secured loans to be securities. Our holding applies only to cases where the "borrower" risks an out-of-pocket loss in return for financial gain. Our holding does not apply to typical secured loans where the borrower cannot be required to honor the promissory obligation without a redemption of the collateral.

The elements of the Nationwide plan we rely upon to hold it a security are present in a wide variety of financial transactions. For example, a savings account or insurance policy, like a corporate bond, subject the investor to some risk of capital loss in return for a relatively fixed return. These transactions are explicitly exempted from the registration requirements of the 1933 Act, 15 U.S.C. § 77c, not because investors do not need protection, but because other agencies regulate the institutions involved.

Memorandum Opinion and Order Denying Motion to Dismiss.

United States District Court, Southern District of California.

Mary F. El Khadem, Plaintiff, vs. Equity Securities Corporation, a Corporation and Equity Funding Corporation, Lyman Spurlock, an Individual, Defendants. Civil No. 71-151-CW.

Filed: Jan. 7, 1972.

Plaintiff brought this action against her investment advisory to recover her losses suffered allegedly in connection with the purchase or sale of a "security." Jurisdiction was invoked pursuant to 15 U.S.C. §§ 77v, 77e, 77q, 78aa, 78j and 78*l*.

Defendants have moved to dismiss on the ground that this Court lacks subject matter jurisdiction in that no "security" was involved in the transactions in question.

FACTS

According to the amended complaint, Lyman Spurlock, an agent acting on behalf of Equity Securities Corp. and Equity Funding Corp., counselled plaintiff to invest in the "investment plan" of Nationwide Investment Corporation. At his behest, she did invest in the plan, which amounted to a series of financial transactions as follows:

1. The investor would borrow money from Nationwide, giving in return (a) a note for the amount of the loan, (b) cash or securities as collateral, and (c) cash as prepayment of the interest (to secure an immediate tax deduction). The investor was required to maintain a collateral to loan ratio of 175%. When

the value of shares pledged as collateral declined, the investor was then required to pledge more collateral.

2. The investor never saw the loan proceeds. Nationwide did not actually obtain the money that was the subject of the loan until it had the investor's note, cash for prepaid interest, and the collateral. With these items, it was able to secure a bank loan to obtain the money.

3. Nationwide then used the loan proceeds to purchase mutual fund shares which were supposed to appreciate over and above the value of the loan by the time of maturity. These mutual fund shares were to be held in an individual escrow account in the investor's name.

4. There were no individual escrow accounts. Instead, Nationwide placed these mutual fund shares in a pooling account in Nationwide's name.

5. Nationwide then repledged this pooled collateral to secure loans from different lending institutions. The proceeds of these loans were used for Nationwide's own business and investment purposes.

6. When the value of plaintiff's mutual fund collateral declined in March, 1970, Nationwide and defendants advised plaintiff to "convert" her assets in mutual funds to Treasury Bills and advised her to execute a second note for the purchase of Treasury Bills, the note again to be secured by plaintiff's collateral.

7. The same pattern of rehypothecation and use of the proceeds by Nationwide followed.

Plaintiff has made no claim that the mutual funds were not registered or lacked a prospectus. She urges either that the promissory notes executed by her con-

stituted a security, or that the entire transaction with Nationwide, including the borrowing of money, the execution of promissory notes, the pleading of collateral and the execution of Loan and Security Agreements, constituted a security which should have been registered pursuant to the federal acts.

DID THE NATIONWIDE PLAN CONSTITUTE A "SECURITY?"

Included within the definition of a "security" are a "note" and an "investment contract." 15 U.S.C. §§77b(1) and 78c(a)(10). Plaintiff contends that both of these statutory definitions have been met.

As to the "note" argument, plaintiff contends that the promissory notes executed by her constitute "notes" within the meaning of the statutory definitions of a "security." Plaintiff points to the case of *Movielab, Inc. v. Berkey Photo, Inc.*, 321 F.Supp. 806 (S.D. N.Y. 1970), which she says stands for the proposition that "the issance of any note tainted with fraud is subject to the anti-fraud provisions of Section 10(b) of the 1934 Act. . . ." Although it is acknowledged that the *Movielab* court has held that a maker of a promissory note may sue on the ground that the note is a "security," (see also *Whitlow & Associates, Ltd. v. Intermountain Brokers, Inc.*, 252 F.Supp. 943 (D. Hawaii 1966)), such a broad position as advocated by plaintiff cannot be accepted by this Court. To so hold would allow federal court jurisdiction to be invoked with respect to any claim of § 10(b) "fraud" by the maker or payee in connection with the issuance of a check or note of whatever denomination, so long as an instrumentality of interstate commerce such as the telephone

were used. This Court is of the opinion that Congress did not intend to establish jurisdiction on such a wide open basis.

The more persuasive argument is that the series of transactions between the plaintiff and Nationwide constituted an "investment contract." In its order of October 6, 1971, granting defendants' motion to dismiss with leave to amend, this Court set forth a number of factors which it felt were relevant and material to the question of whether or not an "investment contract" and hence a "security" had been established. The Court did not intimate that all of these factors were conditions precedent to a finding of jurisdiction. After evaluating plaintiff's amended complaint filed in response to the order in light of relevant case law, this Court is satisfied that plaintiff's allegations are sufficient to support a finding of jurisdiction.

The Supreme Court cases dealing with the term "investment contract" make it clear that that term was meant to embrace all schemes, however novel or subtle, the economic reality of which allowed promoters to obtain the use of other's money on the promise of profits. *S.E.C. v. Howey Co.*, 328 U.S. 293, 299 (1946). In that case, the court held that Congress had adopted the meaning of "investment contract" which had crystallized under state "blue sky" laws, or a ". . . scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.'" 328 U.S. at 298. In paraphrasing this definition, the court further stated ". . . an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to

expect profits solely from the efforts of . . . a third party. . . ." *Id.*

Although the fraudulent pooling of collateral in this case in and of itself may not have constituted a "common enterprise" in the commonly understood meaning of that term, it is clear from the allegations of the amended complaint that the fortunes of those who invested in the Nationwide plan paralleled those of Nationwide. Stripped to its essentials, plaintiff and others like her were giving Nationwide cash and securities (in the form of prepaid interest and collateral) and the use of their credit (by the promissory notes executed) so that Nationwide could obtain capital for its operations. This use of the investor's money was obtained on the reassurance that the mutual funds which were purchased with the plaintiff's loan proceeds would appreciate in value over and above the amount of prepaid interest, thus providing a favorable return to the investor.[1] Since plaintiff's collateral was rehypothecated by Nationwide and the proceeds thereof were used by Nationwide for its own investment purposes, the security of plaintiff's investment in fact depended upon the managerial ability and financial integrity of Nationwide. Plaintiff was clearly led to believe that she was participating in an investment opportunity[2], and she was allegedly acting in reliance on the advice of the defendant and Nationwide in the

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[1]Paragraph 7 of Amended Complaint.

[2]"The purpose of this loan is to provide funds to BORROWER for the purchase and financing of government bonds having a maturity date at least fifteen (15) years from the date of this loan, with the objective of providing capital gains investment opportunity to the BORROWER." Paragraph 11 of Exhibit "F" of plaintiff's Amended Complaint. See also paragraph 7 of plaintiff's Amended Complaint.

"conversion" of her collateral to Treasury Bills.[3] Although plaintiff was nominally given some control over the disposition of the proceeds of her "loan,"[4] she allegedly in fact did not have the requisite sophistication to understand the meaning of the recommendations that were urged upon her by defendants.[5] As stated in *Continental Marketing Corp. v. Securities & Exchange Com'n.*, 387 F.2d 466, 470 (10th Cir. 1967), "The more critical factor is the nature of the investor's participation in the enterprise. If it is one of providing capital with the hopes of a favorable return then it begins to take on the appearance of an investment contract. . . ."

Under such circumstances, the scheme involved here clearly falls within the spirit, if not the letter, of an "investment contract." Viewing the net alleged economic effect of the series of transactions, plaintiff was in exactly the same shoes as anyone who had made a more common variety of an investment contract; in hopes of a favorable return, she had placed her capital at the disposal of others. As reiterated by the Supreme Court in *Tcherepnin v. Knight,* 389 U.S. 332, 338 (1967), the term "security" " 'embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others or the promise of profits.' "

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[3]Paragraph 10 of Amended Complaint.

[4]". . . BORROWER shall be permitted in BORROWER'S sole discretion to initially direct investment of the loan proceeds in Treasury Bills and cash equivalents acceptable to LENDER for such period as BORROWER believes investment factors dictate, subject to a maximum period of six (6) months from the date of this loan agreement." Paragraph 11 of Exhibit "F" of plaintiff's Amended Complaint.

[5]Paragraph 10 of Amended Complaint.

In view of this Court's holding, it is unnecessary to reach plaintiff's contention that the "bonus" certificate of shares in Nationwide constitutes a "security" which would support jurisdiction in this action.

Although also unnecessary to the decision here, and although not urged by plaintiff, it appears that there would be jurisdiction under the Investment Adviser Act (15 U.S.C. §80b-6), which does not involve the question of whether a "security" was involved.

For the reasons stated, the motion to dismiss is hereby denied.

Dated: January 6, 1972.

/s/ J. Clifford Wallace

J. Clifford Wallace
United States District Judge

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